80-2204

No.

Office-Supreme Court, U.S.
FILED
JUN 25 1981
ALEXANDER L. STEVAS,
CLERK

In the Supreme Court of the United States

October Term, 1981

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

NORMAN E. BEAL
(Counsel of Record)
HILLIX, BREWER, HOFFHAUS & WHITTAKER
2715 Commerce Tower
P.O. Box 13367
Kansas City, Missouri 64199
(816) 221-0355

DORSEY, WINDHORST, HANNAFORD,
WHITNEY & HALLADAY
2200 First Bank Place East
Minneapolis, Minnesota 55402
(612) 340-2600
Counsel for Petitioners

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, (816) 421-3030

QUESTION PRESENTED

Does the donor of appreciated property, given on condition that the donee agree to pay the resulting gift taxes, realize taxable income upon the donee's payment of the gift taxes?

TABLE OF CONTENTS

Opinions Below 2
Jurisdiction 2
Statutory Provisions Involved 2
Statement of the Case 5
Reasons for Granting the Petition 7
I. Conflicts Between Courts of Appeals 8
II. Cases Pending in Courts of Appeals 9
III. Eighth Circuit's Ruling Below 10
IV. Conclusion 12

Appendix:

A—Eighth Circuit Opinion Below A1
B—Tax Court Opinion in *Grant* A12
C—Tax Court Opinion in *Diedrich* A17
D—Judgment of Eighth Circuit Below A23
E—Eighth Circuit's Order Denying Rehearing *En Banc* A25

Table of Authorities

CASES

Benson v. Commissioner, 37 T.C.M. (CCH) 989 (1978) 9
Bradford v. Commissioner, 70 T.C. 584 (1978) 9
Diedrich v. Commissioner, 39 T.C.M. (CCH) 433 (1979), *rev'd* 643 F.2d 499 (8th Cir. 1981) 2, 7, 10
Estate of Davis v. Commissioner, 469 F.2d 694 (5th Cir. 1972) 8
Estate of Henry v. Commissioner, 69 T.C. 665 (1978) 9
Estate of Levine v. Commissioner, 72 T.C. 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980) 9
Estate of Owen v. Commissioner, 37 T.C.M. (CCH) 272 (1978) 9

Estate of Weeden v. Commissioner, 39 T.C.M. (CCH) 699 (1979) 9
Evangelista v. Commissioner, 71 T.C. 1057 (1979), *aff'd* 629 F.2d 1218 (7th Cir. 1980) 9
Grant v. Commissioner, 39 T.C.M. (CCH) 1088 (1980), *rev'd* 643 F.2d 499 (8th Cir. 1981) 2, 7, 10
Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) 8, 11
McNeice v. Commissioner, 41 T.C.M. (CCH) 969 9
Molinara v. Estate of Warren, Federal Tax Reporter ¶9362 (March 24, 1981) 10
Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd sub nom. Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969) 8

STATUTES

Internal Revenue Code of 1954, 26 U.S.C. § 1, *et seq.*:
Section 61, 26 U.S.C. 2, 11
Section 102, 26 U.S.C. 3, 8, 11
Section 1001, 26 U.S.C. 3
Sections 2501, *et seq.*, 26 U.S.C. 11
Section 2502, 26 U.S.C. 4
Section 6213, 26 U.S.C. 6
Section 6324, 26 U.S.C. 4
Section 6901, 26 U.S.C. 4
Section 7805, 26 U.S.C. 4
Section 7482, 26 U.S.C. 6
Section 1254, 28 U.S.C. 2

MISCELLANEOUS

Revenue Ruling 75-72, C.B. 1975-1 310 ..... 5, 7

No.

In the Supreme Court of the United States

October Term, 1981

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

COME NOW Petitioners Victor P. Diedrich and Frances T. Diedrich and United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, deceased, through their attorneys, and petition this Court for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit.

OPINIONS BELOW

The opinion of the Court below is reported as *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981). That opinion reversed decisions of the United States Tax Court reported as *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979) and *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980) which had been consolidated in the Court of Appeals for argument and disposition. For convenience, these cases will be referred to as *Diedrich* and *Grant*.

JURISDICTION

The opinion of the United States Court of Appeals for the Eighth Circuit was filed March 4, 1981, and judgment was entered on that day. On May 13, 1981, and March 17, 1981, petitions for rehearing en banc were filed respectively by counsel for *Diedrich* and *Grant*. These petitions were denied by the Court of Appeals on March 27, 1981. Copies of the orders of the Court of Appeals denying the petitions for rehearing are included in the Appendix E at pages A25 and A26. Jurisdiction by writ of certiorari is vested in the United States Supreme Court by 28 U.S.C. § 1254 (1976).

STATUTORY PROVISIONS INVOLVED

Section 61 of Title 26 U.S.C. provides:

> Except as otherwise provided in this sub-title, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rent;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuity;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect to a decedent; and

(15) Income from an interest in an estate or trust.

Section 102 of Title 26 U.S.C. provides in relevant part:

(a) Gross income does not include the value of property acquired by gift, bequest, devise or inheritance.

Section 1001 of Title 26 U.S.C. provides in relevant part:

(a) The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the

excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) The amount realized from the sale or the disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 2502 of Title 26 U.S.C. provides in relevant part:

(d) The tax imposed by 2501 shall be paid by the donor.

Section 7805 of Title 26 U.S.C. provides in relevant part:

(a) Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Section 6324 of Title 26 U.S.C. provides in relevant part:

(b) Except as otherwise provided in subsection (c), unless the gift tax imposed by chapter 12 is sooner paid in full or becomes unenforceable by reason of lapse of time, such tax shall be a lien upon all gifts made during the calendar year, for 10 years from the date the gifts are made. If the tax is not paid when due the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.

Section 6901 of Title 26 U.S.C. provides in relevant part:

(a) the amounts of the following liabilities shall, except as hereinafter in this Section provided, be assessed, paid and collected in the same manner and subject to the same provisions and limitations as in

the case of the taxes with respect to which the liabilities were incurred:

(1) Income, estate and gift taxes—

(a) The liability, at law or in equity, of a transferee of property—

* * *

(iii) of a donor in the case of a tax imposed by chapter 12 (relating to gift taxes),

in respect of the tax imposed by sub-title A or B.

Revenue Ruling 75-72 provides in relevant part:

> If at the time of the transfer, the gift is made subject to a condition that the gift tax be paid by the donee or out of the transferred property, the donor receives consideration for the transfer in the amount of gift tax to be paid by the donee. Under these circumstances, the value of the gift is measured by the fair-market value of the property or property right or interest passing from the donor, minus the amount of the gift tax to be paid by the donee.

STATEMENT OF THE CASE

This case involves another round in the Commissioner of Internal Revenue's attempt to treat federal gift tax paid by the donee of a gift as income to the donor. The Commissioner proposed income tax deficiences against both taxpayers for failure to include as income in their federal income tax returns federal gift tax paid by the donees of gifts made by taxpayers. Separate petitions for redetermination of the deficiences were filed in the United States

Tax Court, which had jurisdiction under 26 U.S.C. § 6213 (1976). In separate opinions, the United States Tax Court held that the donors did not realize income as the result of the donees paying the federal gift tax. The Commissioner appealed both cases pursuant to 26 U.S.C. § 7482 (1976). The cases were consolidated for decision before the United States Court of Appeals for the Eighth Circuit.

The relevant facts are undisputed and there are no material distinctions between the two cases consolidated in this petition. Accordingly, the factual situation will be described by reference to the *Grant* case. In 1970, in reliance on existing law, Frances D. Grant gave 50,000 voting trust certificates, representing underlying common stock of BMA Corporation, to her son subject to his express agreement to pay the resulting gift taxes. In January, 1971, Mrs. Grant gave an additional 40,000 voting trust certificates to her son subject to the same condition. The gift taxes on both transfers were due in the spring of 1971 and these taxes, totalling $232,630, were paid by Mrs. Grant's son.

Mrs. Grant did not report any income in connection with the net gifts in either her 1970 or 1971 federal income tax returns. The Commissioner of Internal Revenue, however, determined that these gifts resulted in taxable income to Mrs. Grant computed as follows:

Gift taxes paid	$232,630.09
Less: Basis in securities transferred	8,742.60
Long-term capital gain	223,887.49
50% deduction for capital gain	111,943.74
Increase in taxable income	$111,943.75

The Commissioner theorized that Mrs. Grant's gifts were, in part, sales of the property to her son and her gain was

measured by the difference between the gift taxes paid by Mrs. Grant's son and her basis in the voting trust certificates.

Mrs. Grant filed a petition for redetermination of the proposed deficiencies in the United States Tax Court. In a Memorandum Opinion filed February 27, 1980, Mrs. Grant's motion for judgment on the pleadings was sustained and the proposed deficiencies were set aside. The Tax Court's opinion in favor of the taxpayer in *Diedrich* was filed on February 13, 1980. The Commissioner's appeals from the Tax Court's decisions in *Grant* and *Diedrich* were consolidated for oral argument and disposition in the United States Court of Appeals for the Eighth Circuit. On March 4, 1981, the Court of Appeals reversed the Tax Court's decision in each case. The Court of Appeals held that the taxpayers in both *Grant* and *Diedrich* received a benefit upon payment of the gift taxes by the donees and that the benefits received resulted in taxable income measured by the difference between the gift taxes paid and the donors' adjusted bases in the property.

REASONS FOR GRANTING THE PETITION

These cases involve the *income tax* consequence of a popular tax and estate planning technique commonly referred to as a "net gift." In a net gift transaction, the donee pays the gift taxes and with a "pure" net gift the donor does not personally realize any money or other property. The technique has been in use for many years and has been the subject of litigation relating to various aspects of the transaction since 1942. The gift tax consequences are established: for gift tax purposes, the value of the gift equals the value of the property transferred less the gift taxes paid. Rev. Rul. 75-72. The issue in these cases is

whether or not there is an *income tax* consequence to the donor of a pure net gift of appreciated property.

I. Conflicts Between Courts of Appeals

The United States Tax Court first considered this question in *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd sub nom. Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969). In that case, the taxpayer made gifts of appreciated stock outright to several individuals and in trust for certain other individuals. All of the gifts were subject to an express condition that the donees pay the resulting gift taxes, which was done. The question before the Tax Court was identical to the question presented here, whether the payment by the donees of the federal gift tax resulting from the gifts resulted in income to the taxpayer. The Tax Court held that the donees' payment of the gift tax did *not* result in income to the taxpayer. In reaching that conclusion, the Tax Court reasoned that the condition imposed by a transferor that the transferee pay the gift tax resulting from the transfer does not alter the nature of the transfer as a gift. *Id.* at 362. Because gifts are not taxable as income to either the donor on the donee, 26 U.S.C. § 102 (1976), and because the Tax Court found that the transfer in question was a gift, the Tax Court held that the gifts did not result in a taxable gain to the taxpayer. *Turner v. Commissioner*, 49 T.C. at 364. The Tax Court's decision was affirmed by the Sixth Circuit. *Commissioner v. Turner*, 410 F.2d 752 (6th Cir. 1969).

The holding in *Turner v. Commissioner*, was followed by the United States Courts of Appeals for the Fourth and Fifth Circuits in cases involving substantively identical facts. *Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner*, 469 F.2d 694 (5th Cir. 1972). In cases not involving net gifts the Courts of Ap-

peals for two additional circuits have suggested in dicta how they would decide net gift cases. In *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980), the Second Circuit suggests it would decide the net gift question in favor of the Commissioner. In *Evangelista v. Commissioner*, 71 T.C. 1057 (1979), *aff'd* 629 F.2d 1218 (7th Cir. 1980), the Seventh Circuit suggests it would decide the net gift question in favor of the taxpayer.

II. Cases Pending in Courts of Appeals

The Tax Court has decided six net gift cases which are now on appeal to the Courts of Appeals. *Bradford v. Commissioner*, 70 T.C. 584 (1978) (Commissioner on appeal to Sixth Circuit); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978) (Commissioner on appeal to Sixth Circuit); *McNeice v. Commissioner*, 41 T.C.M. (CCH) 969 (Commissioner on appeal to Ninth Circuit); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979) (Commissioner on appeal to Ninth Circuit); *Estate of Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978) (Commissioner on appeal to Sixth Circuit); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978) (Commissioner on appeal to Sixth Circuit). All involve pure net gifts and were decided in favor of the taxpayers. Substantial asserted tax liabilities are at stake, to wit:

Estate of Henry—$686,000
Benson—$16,500
Bradford—$125,000
Owen—$502,000
McNeice—$148,000
Estate of Weeden—$23,000.

In addition, the United States District Court for the Northern District of Iowa followed the Eighth Circuit's *Diedrich* ruling in *Molinaro v. Estate of Warren,* Federal Tax Reporter ¶9362 (March 24, 1981). This case, which is a refund action, is currently on appeal to the Eighth Circuit, but that Court has stayed consideration of the appeal pending this Court's ruling on this Petition.

III. Eighth Circuit's Ruling Below

The Commissioner has asserted basically two theories for imposing an income tax on net gifts. The first is that the net gift is a part gift, part sale transaction. In these cases, as well as in the other net gift cases it has considered, the Tax Court has found that the transfers were intended as gifts, not as sales. A gift does not give rise to income and the Commissioner's theory has been uniformly rejected. This theory of taxation has largely been abandoned by the Commissioner. Although this was the theory of the proposed deficiency in *Grant,* it was not urged by the Commissioner before the Eighth Circuit and it was not discussed by the Court.

The Commissioner asserted before the Eighth Circuit that the taxpayers in *Grant* and *Diedrich* recognized a real and substantial economic benefit. The Eighth Circuit agreed, finding that a taxable benefit had been realized when the gift tax liability was discharged. *Diedrich v. Commissioner,* 643 F.2d 499, 504.

The petitioners respectfully submit that the Eighth Circuit's decision is erroneous. It is based upon a finding that they are somehow "better off" as a result of the gifts. Before the gifts were made, these taxpayers owed nothing and by virtue of the gifts they received nothing. They were not better off after the gifts were made; they were simply not worse off, as they would have been had they

paid the gift taxes themselves. *See, Hirst v. Commissioner*, 572 F.2d at 431.

Generally, gross income means all income from whatever source derived. 26 U.S.C. § 61 (1976). However, gross income does not include the value of property acquired by gift. 26 U.S.C. § 102 (1976). Although there is no section specifically excluding value accruing to the donor of a gift, an entirely separate taxing scheme was established for gifts. 26 U.S.C. §§ 2501, *et seq.* (1976). This is a clear Congressional recognition that the transfer of property by gift is not an income producing event. By its very nature, a gift is not a transfer involving a taxable gain to the donor.

The decision by the Eighth Circuit in these cases is the first instance in which income taxes were found to be payable on a pure net gift of appreciated property. The Commissioner's arguments have been rejected in every other pure net gift case. The petitioners respectfully submit that the Eighth Circuit is wrong and that the Fourth, Fifth and Sixth Circuits, and the United States Tax Court, are right. A gift is not an income producing transaction.

These cases present an important question of tax law on which the Courts of Appeals are squarely divided. Three circuits have decided in favor of the taxpayer and one circuit has indicated its approval of these decisions. The Eighth Circuit in this case has decided in favor of the government and the Second Circuit has suggested that it would also rule in favor of the government. The other circuits have yet to rule. This split causes taxpayers in the Eighth Circuit to be subject to taxes not imposed on taxpayers carrying out identical transactions in the Fourth, Fifth and Sixth Circuits.

The net gift has been widely used as a tax and estate planning device. It has been extensively considered by the

commentators. A final determination of the income tax consequences of the net gift is needed to eliminate the present split between Circuits and to provide the basis for taxpayers reliance and planning in the future.

IV. Conclusion

The petition for Writ of Certiorari should be granted.

Respectfully submitted,

By NORMAN E. BEAL
HILLIX, BREWER, HOFFHAUS & WHITTAKER
2715 Commerce Tower
Kansas City, Missouri 64199
(816) 221-0355

June 25 1981.

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
For The Eighth Circuit

No. 80-1376

Victor P. Diedrich and Frances T. Diedrich,
Appellees,

v.

Commissioner of Internal Revenue,
Appellant.

Appeal from the United States
Tax Court

No. 80-1421
United Missouri Bank of Kansas City, N.A., Executor
of the Estate of Frances D. Grant, Deceased,
Appellee,

v.

Commissioner of Internal Revenue,
Appellant.

Appeal from the United States
Tax Court

Submitted: January 15, 1981
Filed: March 4, 1981

Before BRIGHT, STEPHENSON and McMILLIAN, Circuit Judges.

STEPHENSON, Circuit Judge.

The Commissioner of Internal Revenue appeals from two tax court decisions[1] in favor of the taxpayer-appellees. The cases have been consolidated for argument and decision in this court. The Commissioner unsuccessfully asserted in the tax court that when a donor gratuitously transfers property on the condition that the donee pay the resultant gift tax, income accrues to the donor to the extent the amount of gift tax paid exceeds the donor's basis in the property transferred.[2] Ruling in favor of the taxpayers that no income was realized, the tax court held that the transfers were "net gifts" of the difference between the fair market value of the stock and the gift tax paid. We reverse.

The material facts in both 80-1421 and 80-1376 are undisputed. In both cases the taxpayer made a gift of low basis, highly appreciated securities to a family member.[3] The gifts were expressly conditioned on the donees' promise to pay all state and federal gift taxes arising from the transfers. Taxpayers reported no income in connection with the stock transfers. The Commissioner determined

---

1. *Diedrich v. Commissioner*, 39 T.C.M. (CCH) 433 (1979), *on appeal* (8th Cir. No. 80-1376); *Grant v. Commissioner*, 39 T.C.M. (CCH) 1088 (1980), *on appeal sub nom. United Missouri Bank v. Commissioner* (8th Cir. No. 80-1421).

2. The Internal Revenue Service also argues the gain is taxable in the years the gift tax was paid, rather than the years the transfer was made. Both taxpayers concede this issue, if this court determines that any taxable gain was realized.

3. In *Diedrich*, 80-1376, taxpayers transferred stock to their son outright and in trust to their son for the benefit of their daughters. In *United Missouri Bank*, 80-1376, taxpayer made the gift outright to her son.

that the transfers resulted in taxable income to the donors in the years in which the gift tax was paid.[4] The tax court held for taxpayers.

Appellant Commissioner's position is that when donors transfer highly appreciated, low basis stock subject to the condition that the donees pay the resulting gift tax, income is realized to the extent the gift tax liability exceeds the donor's basis in the transferred property. The Commissioner contends that the real and substantial economic benefit taxpayers received by having their taxes paid is a taxable accretion to wealth. Section 1001 of the Internal Revenue Code[5] provides that the gain from the sale or other

---

4. The deficiency claimed in *Diedrich*, 80-1376, is $5,959. It was computed as follows:

Gift tax paid in 1972	$ 62,992
Less basis in stock transferred	51,073
Long term capital gain	11,919
50% deduction for captial gain (I.R.C. § 1202)	5,959
Increase in taxable income	$ 5,959

The deficiency claim in *United Missouri Bank*, 80-1421, is $111,943.75. It was computed as follows:

Gift tax paid in 1971	$232,630.09
Less basis in stock transferred	8,742.60
Long term capital gain	223,887.49
50% deduction for capital gain (I.R.C. § 1202)	111,943.75
Increase in taxable income	$111,943.75

5. I.R.C. § 1001 provides:

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property. The amount realized is the sum of any money received plus the fair market value of any other property received. Because the payment of federal gift taxes is the legal responsibility of the donor,[6] the Commissioner contends that the donor realizes income in the amount of the gift taxes paid by the donee. The Commissioner relies on *Crane v. Commissioner*, 331 U.S. 1 (1947) (non-recourse mortgage is included in the basis of property and must be included in the amount realized upon sale) and *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (discharge of taxpayer's income tax liability by employer results in income to taxpayers) for the proposition that an amount realized by the taxpayer may include non-cash consideration. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.* at 729.[7]

---

6. I.R.C. § 2502(d) provides:

(d) *Tax to be paid by donor.*—The tax imposed by section 2501 [the gift tax] shall be paid by the donor.

7. *See also Malone v. United States*, 326 F. Supp. 106 (N.D. Miss. 1971), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972) (when taxpayer transferred mortgaged property to trust upon condition that trustee pay the indebtedness, taxpayer realized gain to the extent the value of property exceeded the mortgage); *First National Industries, Inc. v. Commissioner*, 26 T.C.M. (CCH) 608 (1967), *aff'd*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969) (when taxpayer gave appreciated stock subject to the condition that donee sell the stock and use the proceeds to pay the indebtedness, taxpayer realized income to the extent the obligation discharged exceeded its adjusted basis); *Simon v. Commissioner*, 32 T.C. 935 (1959), *aff'd*, 285 F.2d 422 (3d Cir. 1960) (when taxpayer transferred mortgaged building to corporation, contending he had made a contribution to capital, taxpayer realized gain to the extent the mortgage exceeded his adjusted basis).

The *Crane* doctrine has been given a great deal of discussion by the commentators. *See, e.g.*, Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 Tax L. Rev. 277 (1978); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. Pa. L. Rev. 69 (1969); Adams, *Exploring the Outer Boundaries of the Crane Doctrine; an Imaginary Supreme Court Opinion*, 21 Tax L. Rev. 159 (1966).

Taxpayer-appellees distinguish *Crane* and *Old Colony Trust* on the basis that they involved pre-transfer realization of some portion of the appreciated value of the property. They argue these decisions have never been applied to a "pure" net gift in which the donor does not personally realize any money or other property representing any portion of the appreciated value of the property. Taxpayers rely instead on a line of cases from the tax court beginning with *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.*, 1971-2 C.B. 4, which hold that transfers identical to the ones at issue here are "net gifts"[8] which produce no taxable income to the donor.

The basic facts in *Turner* are indistinguishable from those here. Taxpayer made gifts of low basis stocks to several donees, including trusts, subject to the condition that each donee pay the gift tax which arose due to the transfer. The Commissioner of Internal Revenue asserted that the transactions constituted part sales and part gifts; that is, that they were sales to the extent that the gift tax payable exceeded the donor's basis. In his brief, however, the Commissioner conceded that the transfers to the trust were not sales, since the trustees incurred no personal liability on the gift tax. The tax court thought the distinction between the individual transfers and transfers in trust was untenable, as they were "substantially identical." 49 T.C. at 363. It treated the transfers as net gifts, based on the rationale that the donor had intended to give only

---

8. For gift tax purposes, a gift conditioned on the donee's payment of the gift tax is called a net gift. Only that portion of the value of the property transferred which exceeds the amount of gift taxes due on the transfer is considered to have been transferred with donative intent, and therefore characterized a a gift, subject to gift taxes. *Pamelo Lingo v. Commissioner*, 13 T.C.M. (CCH) 436, 441 (1954); *Sarah Helen Harrison*, 17 T.C. 1350 (1952), *acq.*, 1952-2 C.B. 2; Rev. Rul. 81-232, 1971-1 C.B. 275. This concept, of course, applies only for gift tax purposes and is not relevant to income tax consequences.

the value of the shares less the value of the gift tax payable on the transfers. In other words, the donor is said to have retained income for her own benefit from the transaction to the extent of the gift tax. Some courts have viewed the "retained interest" theory as an alternative to the economic benefit approach advanced by the Commissioner. The *Turner* rationale has been followed in all subsequent tax court decisions with similar facts. *See, e.g., Owen v. Commissioner,* 37 T.C.M. (CCH) 272 (1978), *appeal docketed,* No. 78-1341 (6th Cir.); *Estate of Henry v. Commissioner,* 69 T.C. 665 (1978); *Hirst v. Commissioner,* 63 T.C. 307 (1974), *aff'd,* 572 F.2d 427 (4th Cir. 1978) (en banc); *Estate of Davis v. Commissioner,* 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam,* 469 F.2d 694 (5th Cir. 1972).

We agree with the Commissioner that *Turner* and its progeny were incorrectly decided. As we view this problem, the correct approach was taken by *Johnson v. Commissioner,* 59 T.C. 791 (1973), *aff'd,* 495 F.2d 1072 (6th Cir.), *cert. denied,* 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner,* 72 T.C. 780 (1979), *aff'd,* 634 F.2d 12 (2d Cir. 1980). *Johnson* presents facts somewhat different than those presented here. A taxpayer borrowed $200,000 from a bank without recourse and secured the note with 50,000 shares of stock with a fair market value of $500,000 and a basis of about $11,000. Shortly thereafter the taxpayer transferred the stock to an irrevocable trust for the benefit of his children, and the trustees replaced the taxpayer's note with their own note secured by the same 50,000 shares of stock. The taxpayer paid $150,000 in gift tax from the $200,000 proceeds of the original note, leaving him $50,000 in cash. The Sixth Circuit affirmed the tax court's decision in favor of the Commissioner of Internal Revenue. It held the full value of the loan taxable on any one of three theories: (1) the $200,000 received by Johnson was gross income because

it was "income from whatever source derived"[9] and it made no difference that it was used in part to pay gift tax; (2) because section 2052(d) makes the payment of gift taxes the donor's legal obligation, the payment of that liability by the donee was equivalent to a receipt of money to the donor; (3) the principles of *Crane v. Commissioner, supra,* apply because the taxpayer actually received cash without liability to repay the notes out of his own assets. Moreover, *Johnson* stated that *Turner,* in view of the concessions made in the briefs, had "no precedential value beyond its peculiar fact situation." *Johnson v. Commissioner, supra,* 495 F.2d at 1086. The Commissioner had espoused in *Johnson,* and the tax court had accepted, the theory that the net gift was actually a "part sale and part gift," that is, that the donor sold his gift for the price of having his gift tax paid by the donee. The court emphasized that whether the transaction was called a "part gift and part sale" or a "net gift" had no import, because, regardless of terminology, the taxpayer received something of value upon the transfer. Thus, argues the Commissioner here, the broad holding of *Johnson* is that the taxpayer receives something of value upon payment by another of his obligation, and that something of value is subject to income tax.

In *Estate of Levine v. Commissioner, supra,* taxpayer made a gift of real estate encumbered by $780,000 in nonrecourse mortgages to a trust for the benefit of his three grandchildren. The donee-trust assumed the mortgage plus (1) taxpayer's obligation to pay accrued interest in the amount of $5,908.34 with respect to the mortgages, and

---

9. Gross income is defined by I.R.C. § 61:

(a) *General definition.*—Except as otherwise provided in this subtitle, gross income means *all income from whatever source derived,* including (but not limited to) the following items: * * *

(emphasis added).

(2) real estate operating expenses of $125,000 for the year prior to the gift. The question presented was whether the donor realized gain to the extent the mortgage was in excess of his adjusted basis in the transferred property. Relying on *Crane* and *Old Colony Trust*, the Second Circuit (Friendly, J.) held taxable gain was realized. Although no net gift issue was involved in *Estate of Levine*, taxpayer attempted to rely on the *Turner* line of cases. In dictum the Second Circuit stated that it believed its decision consistent with *Johnson* and the *Hirst* dissent because Levine's expenses, like the gift taxes, were a personal liability of the donor. *Estate of Levine v. Commissioner*, *supra*, 634 F.2d at 17.[10] *See also Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980) (transfer of encumbered automobiles and contemporaneous assumption of liability by transferee results in gain to transferor to extent liability assumed exceeds adjusted basis in assets transferred).

Appellees attempt to distinguish *Johnson* and *Estate of Levine*. They claim first that *Johnson* must be limited to its own facts because it has not been followed in subsequent tax court cases with "pure" net gift facts,[11] or in the Fourth Circuit's *Hirst* opinion.[12]

---

10. The court also stated that "[w]hile the facts in *Johnson* were peculiarly favorable to the Commissioner, we consider that it effectively overruled *Turner* as a precedent." *Estate of Levine v. Commissioner*, 634 F.2d 12, 17 (2d Cir. 1980).

11. *E.g.*, *Krause v. Commissioner*, 56 T.C. 1242 (1971); *Estate of Davis v. Commissioner*, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978); *Owen v. Commissioner*, 37 T.C.M. (CCH) 272 (1978); *Benson v. Commissioner*, 37 T.C.M. (CCH) 989 (1978), *appeal docketed*, No. 79-1032 (6th Cir.); *Bradford v. Commissioner*, 70 T.C. 584 (1978), *appeal docketed*, No. 79-1094 (6th Cir.); *Estate of Weeden v. Commissioner*, 39 T.C.M. (CCH) 699 (1979), *appeal docketed*, No. 80-7127 (9th Cir.).

12. In *Hirst*, a mother gave three tracts of land to her son's family on the son's agreement to pay resulting gift taxes. The

(Continued on following page)

Johnson is further distinguished by appellees on its facts. Johnson, before making the gift, personally realized a substantial portion of the appreciated value of his stock, and he himself paid the gift tax. This is in contrast to the instant cases, in which the donee's agreement to pay the gift tax does not arise but for the net gift itself. *Estate of Levine* is similarly distinguishable on the basis that it involved a transfer of property encumbered by preexisting obligations.

We do not believe it significant that the transfers in *Johnson* and *Estate of Levine* involved preexisting encumbrances. It is a well-established principle of tax law

---

Footnote continued—

tax court held the transaction was a net gift and not subject to income tax. However, the court recognized the validity of the Commissioner's position:

> *We recognize that there is much force to the Government's position.* The gift tax itself is imposed only upon the "net gift," i.e., upon the gross amount of the property transferred minus the gift tax paid by the donee. In substance, a portion of the transferred property equal in value to the amount of the gift tax is not treated as having been part of the gift. But surely that portion did not vanish into thin air, and a strong argument can be advanced for the conclusion that it was exchanged for the donee's payment of the gift tax on the "net gift," a transaction that may result in the realization of gain or loss depending upon the donor's basis in the property. If the donor had sold that portion to an outsider immediately prior to the gift of the remainder, and then used the proceeds of the sale to pay the gift tax, the practical consequences to the donor would have been the same as in *Turner*, except that the donor would have been taxable on any gain realized on the sale. *However, in the absence of any clear-cut overruling of prior law by a Court of Appeals, we are not prepared at this time to reexamine an intricate and consistent pattern of decision that has evolved over the years in this field, notwithstanding that there may be much to be said in favor of a more "realistic" approach to the problem. Things have gone too far by now to wipe the slate clean and start all over again.*

63 T.C. at 315 (emphasis added). *Hirst* was affirmed in a Fourth Circuit opinion en banc, 572 F.2d 427. The dissent vigorously asserted that *Johnson* was decided correctly and *Turner* was decided incorrectly.

that when a taxpayer constructively receives income, he is subject to income tax liability. It makes no difference whether he receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit. Nor it is relevant to our conclusion that the liability arose at the time of the transfer as opposed to before the transfer. The consequence to the donor is the same regardless of when the obligation arose.

We agree with District Judge Thomsen's dissent in *Hirst*,[13] joined by two members of the en banc court, that when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income. Here, as in *Hirst*, "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities." *Id.*, 572 F.2d at 438. As one commentator has noted, "terming the transaction a net gift does not alter the fact that despite the transferor's intention, he is actually transferring the entire property and receiving something in return. His intent that the transferee receive only a portion of the value of the property cannot eliminate that essential fact of economic life." Note, *Taxation—Conditional Net Transfers: No Income Tax Consequences to Donor—Hirst v. Commis-*

---

13. Commentators have generally found the *Hirst* dissent more convincing than the majority opinions. *See, e.g.*, Note, *Taxation—Conditional Net Transfers: No Income Tax Consequences to Donor—Hirst v. Commissioner*, 572 F.2d 427 (4th Cir. 1978), 52 Temple L. Q. 139 (1979). Comment, *Federal Income Tax—Income Taxation of Net Gifts After Hirst v. Commissioner*, 32 Rutgers L. Rev. 389 (1979); *Federal Income Tax—Net Gift Doctrine—No Taxable Income Results from Gift Given Subject to Condition that Donee Pay Gift Tax*, 63 Cornell L. Rev. 1074 (1978). *Contra*, Grier, *Recent Litigation Upholds the Favorable Treatment of the Net Gift Technique*, 48 J. of Taxation 214 (April 1978).

sioner, 572 F.2d 427 (4th Cir. 1978), 52 Temple L. Q. 139, 151 (1979).

We note parenthetically both taxpayers argue that they relied on a long line of tax court decisions in making these transfers, and therefore "stare decisis and fair play" require a ruling in their favor. Appellees in 80-1421 request a remand on the factual question of actual reliance should we rule against them on the legal question. In our opinion, reliance is not controlling because the income tax consequences of this type of transaction had not yet been ruled upon by this circuit at the time of the gifts in question. In any event, "Congress had indicated that, in federal tax law, claims of reliance are to be given little weight." *Gulf Inland Corporation v. United States*, 570 F.2d 1277, 1279 (5th Cir. 1978).

Accordingly, we hold that to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the property transferred, the donors realized taxable income.

The decisions of the tax court are reversed.

A true copy.

Attest:

Clerk, U.S. Court of Appeals,
Eighth Circuit

APPENDIX B

T.C. Memo. 1980-50

UNITED STATES TAX COURT

FRANCES D. GRANT
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

Docket No. 5757-77.

Filed February 27, 1980.

Norman E. Beal, for the petitioner.
Judith M. Wall and *Gary C. Gough*, for the respondent.

MEMORANDUM OPINION

DAWSON, *Judge*: This case was assigned to Special Trial Judge Francis J. Cantrel for the purpose of conducting the hearing and ruling on petitioner's motion for judgment on the pleadings. After a review of the record, we agree with and adopt his opinion which is set forth below.[1]

OPINION OF THE SPECIAL TRIAL JUDGE

CANTREL, *Special Trial Judge*: Respondent in his notice of deficiency determined deficiencies in petitioner's 1970 and 1971 Federal income taxes of $41,908 and $50,237,

---

1. Since this is a pretrial motion for judgment on the pleadings and there is no genuine issue of material fact, the Court has concluded that the post-trial procedures of Rule 182, Tax Court Rules of Practice and Procedure, are not applicable in these particular circumstances. This conclusion is based on the authority of the "otherwise provided" language of that Rule.

respectively. The sole issue for determination is whether petitioner realized a taxable gain upon making gifts of corporate securities to her son conditioned upon her son's paying the resulting gift tax liability.[2]

In her petition, petitioner alleged the facts in support of her claim that no deficiency exists as to her for the taxable years 1970 and 1971. Respondent filed an answer to the petition, admitting many of the alleged facts stated in the petition, and affirmatively alleging facts in support of the determined deficiencies as well as facts to support an increased deficiency for 1971 in the amount of $20,190 pursuant to section 6214(a).[3] On the basis of the facts stated in the petition and admitted by respondent in his answer, petitioner filed the present motion for judgment on the pleadings pursuant to Rule 120, Tax Court Rules of Practice and Procedure.[4] Respondent filed a "Notice of Objection to Petitioner's Motion for Judgment on the Pleadings" on the ground that petitioner did not file a reply to his answer as required by Rule 37(a), and accordingly the case could not be deemed at issue under the provisions of Rule 38. Subsequently, respondent withdrew this objection upon the filing of a reply by petitioner after the Court had granted her leave to file her reply out of time. Respondent filed a memorandum of law containing substantive objections to petitioner's motion for judgment on

---

2. In his notice of deficiency, respondent also adjusted petitioner's medical expense and sales tax deduction. These automatic statutory adjustments depend entirely upon the outcome of the corporate securities gift issue.

3. Since respondent originally determined a $50,237 deficiency in his notice of deficiency, this increase results in an alleged total deficiency for 1971 in the amount of $70,427. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

4. All rule references herein are to the Tax Court Rules of Practice and Procedure.

the pleadings and a hearing was held thereon at the Motions Session in Washington, D.C.

The following facts are undisputed and are taken from those portions of petitioner's petition admitted by respondent in his answer.

Petitioner is an individual over 90 years of age having her legal residence at the time the petition herein was filed in Kansas City, Jackson County, Missouri. She filed her Federal income tax returns for 1970 and 1971 with the Internal Revenue Service at Kansas City, Missouri.

In August 1970, petitioner made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant (William), conditioned upon his paying the gift taxes shown to be due by her gift tax return. On or before April 15, 1971, petitioner filed her gift tax return for 1970 in which she reported the gift, and her son paid, upon the filing of the return, the gift taxes disclosed to be owing on the gift in the amount of $106,334.32. Petitioner's adjusted basis in these Voting Trust Certificates was $4,857.

On or before April 15, 1971, petitioner filed her individual Federal income tax return for the year 1970 and paid with or prior to filing such return the full amount of tax shown to be owing in the amount of $27,754.

In January 1971, petitioner made a gift of 40,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation to her son William, conditioned upon his paying the gift taxes shown to be due on the gift by her gift tax return. On May 20, 1971, petitioner filed her gift tax return for the first quarter of 1971 in which she reported the aforesaid gift, and her son, upon the filing of the return, paid the gift taxes disclosed to be owing on the gift in the amount of $126,295.77. Pe-

titioner's adjusted basis in these Voting Trust Certificates was $3,885.60.

On or before April 15, 1972, petitioner filed her individual Federal income tax return for 1971 and paid with or prior to filing the return the full amount of taxes shown to be owing in the amount of $7,035.

Upon audit of petitioner's income tax returns for 1970 and 1971, respondent determined that petitioner's gifts to her son William, as described above, constituted in part a sale of the Voting Trust Certificates to him. Respondent in his notice of deficiency determined that petitioner realized a long-term capital gain from the disposition of the BMA common stock in the amount that the gift tax paid by her son exceeded her adjusted basis in the property.

Here the petitioner made gifts of stock to her son which were conditioned on her son paying all applicable gift taxes, which he subsequently did pay. The gift tax liability exceeded the total amount of petitioner's basis in the transferred stock.

This case is another of a line of cases involving the net gift versus the part-gift-part-sale issue. Respondent, relying upon *Johnson v. Commissioner*, 59 T.C. 791 (1973), affd. 495 F.2d 1079 (6th Cir. 1974), characterizes the transaction as in part a sale and in part a gift. He contends that since the gift taxes on the transfer were the legal obligation of the donor petitioner, the donee son's payment constituted income which was in effect an amount realized as consideration for the transfer. Accordingly, he claims that the amount of the payment exceeding petitioner's basis in the transferred stock constituted income to her.[5]

---

5. See sec. 2502(d); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

This Court first held in *Turner v. Commissioner*, 49 T.C. 356 (1968), affd. per curiam 410 F.2d 752 (6th Cir. 1969), involving facts similar to those before us, that the transfer constituted a net gift resulting in no income tax liability to the donor. This Court and others have repeatedly followed this approach of characterizing the transfer as a net gift resulting in no tax liability to the donor. *Bradford v. Commissioner*, 70 T.C. 584 (1978), on appeal (6th Cir., Dec. 26, 1978); *Estate of Henry v. Commissioner*, 69 T.C. 665 (1978), on appeal (6th Cir., May 5, 1978); *Hirst v. Commissioner*, 63 T.C. 307 (1974), affd. 572 F.2d 427 (4th Cir. 1978); *Krause v. Commissioner*, 56 T.C. 1242 (1971).[6] Inasmuch as the facts and legal questions presented here are indistinguishable from those previously addressed in these cases, we hold, for the reasons we set forth at length in *Estate of Henry v. Commissioner, supra*, and *Hirst v. Commissioner, supra*, that petitioner did not realize income as a result of her gifts of stock conditioned upon her donee son's payment of the resulting gift taxes.

Accordingly, petitioner's motion for judgment on the pleadings will be granted.[7] In accordance with the foregoing,

An appropriate order and decision will be entered.

---

6. See also, *Estate of Weeden v. Commissioner*, T. C. Memo. 1979-498; *Diedrick v. Commissioner*, T. C. Memo. 1979-441; *Benson v. Commissioner*, T. C. Memo. 1978-231; *Estate of Davis v. Commissioner*, T. C. Memo. 1971-318, affd. per curiam 469 F.2d 694 (5th Cir. 1972).

7. In her petition and motion, petitioner requests that respondent be ordered to pay costs and attorney fees. This request is denied because this Court lacks jurisdiction to award attorney fees. *Key Buick Co. v. Commissioner*, 68 T.C. 178 (1977), on appeal (5th Cir., Aug. 15, 1977).

APPENDIX C

Victor P. Diedrich and Frances T. Diedrich v. Commissioner. Docket No. 1800-77. T. C. Memo. 1979-441. Filed November 6, 1979.

Phillip H. Martin and Bruce J. Shnider, 2300 First Nat'l Bank Bldg., Minneapolis, Minn. for the petitioners. Burns Mossman, for the respondent.

Memorandum Findings of Fact and Opinion

Wiles, Judge: Respondent determined a deficiency of $27,831 in petitioners' 1972 Federal income tax. After concessions, the sole issue for decision is whether petitioners realized income on transfers of stock to or for the benefit of their children where the transfers were conditioned on the donees agreeing to pay Federal and state gift taxes resulting from the transfers.

Findings of Fact

All of the facts have been stipulated and are found accordingly.

Victor P. and Frances T. Diedrich, husband and wife, resided in Owatonna, Minnesota, when they timely filed their 1972 joint Federal income tax return with the Office of the Internal Revenue Service at Ogden, Utah, and when they filed their petition in this case.

On April 1, 1972, Victor P. Diedrich made a gift of 51,073 shares of voting and nonvoting common stock of Owatonna Manufacturing Company, Inc. (hereinafter OMC), to or for the benefit of his three adult children, Eugene F. Diedrich, JoAnn D. Petkus, and Madelyn D. Smith. Also, on April 1, 1972, Frances T. Diedrich made a gift of 60 shares of OMC common stock to her son,

Eugene F. Diedrich. A total of 17,025 shares, consisting of 12,903 shares of voting common stock and 4,122 shares of nonvoting common stock, was transferred outright to Eugene F. Diedrich. A total of 17,024 shares of nonvoting common stock was transferred to each of the irrevocable trusts created by Victor P. Diedrich on April 1, 1972, for the benefit of his daughters, JoAnn D. Petkus (hereinafter the Petkus Trust) and Madelyn D. Smith (hereinafter the Smith Trust). Eugene F. Diedrich was and is the sole trustee for the Petkus and Smith Trusts. Eugene F. Diedrich, the Petkus Trust, and the Smith Trust are hereinafter referred to as the Donees.

At the time the gifts were made, Eugene, for himself and as the trustee of the Petkus and Smith Trusts, signed three agreements on behalf of each of the Donees. The agreements provided that each Donee would pay its share of the Federal and state gift taxes arising from the stock transfers as a condition to receiving the gifts.

For Federal gift tax purposes, petitioners agreed to treat their gifts as if made one-half by each. On or before August 15, 1972, they reported the stock transfers by timely filing Federal gift tax returns for the second quarter of 1972.

The OMC stock transferred to the Donees was valued at $7.80 per share. The gross amount of the gift of 51,073 shares of OMC stock reported on the return was $398,369. After reducing this amount by the Federal and state gift taxes to be paid by the Donees, the net amount of the gift was determined to be $316,869. The resulting Federal gift tax liability of $62,992 on the $316,869 gift was paid by the Donees in 1972.

On or before April 15, 1973, petitioners timely filed a Minnesota gift tax return to report the gifts made in

1972. Minnesota gift taxes of $18,508 were paid by the Donees during 1973.

In order to satisfy the Federal gift tax liability, Eugene, acting in his individual capacity and as trustee of the Petkus and Smith Trusts, borrowed the sum of $62,992 from OMC. Each loan was represented by three separate checks payable to the order of the respective borrower. On or about August 15, 1972, Eugene paid the gift tax, individually and as trustee of the Trusts, by endorsing these checks to the order of the Internal Revenue Service.

To pay the principal and interest on the loans from OMC, the Petkus and Smith Trusts each sold 2,728 shares of OMC stock to OMC in December 1972 at $7.80 per share. Eugene paid the principal and interest on the loans from OMC with his personal funds.

On or before April 15, 1973, the Trusts each sold additional shares of OMC stock at $7.80 per share to pay their respective portions of the Minnesota gift tax in 1973. Eugene again used his personal funds to pay his portion of the state tax in 1973.

Upon audit of petitioners' Federal gift tax returns in 1974, the value of the OMC stock transferred to the Donees was increased from $7.80 to $13.00 per share. Accordingly, the value of the 51,073 shares was determined to be $663,949. The additional Federal and Minnesota gift taxes of $64,213 resulting from the audit were paid by the Donees in 1975.

After the audit gave rise to increased gift tax liabilities, OMC agreed to pay the Petkus and Smith Trusts additional consideration for the purchase of their stock in December 1972. This increased the purchase price to $13.00 per share and OMC also agreed to pay interest to the Trusts

from the date of sale to the date of payment of such additional consideration. Each Trust used these proceeds to pay its respective portion of the additional Federal and Minnesota gift taxes resulting from the audit. Eugene paid his portion of the additional taxes from his personal funds.

Petitioners had a basis of $1.00 per share in the OMC stock transferred to the Donees and, as of the date of the gift, had held this OMC stock longer than six months. One of the reasons they made the gift to Eugene, who is now president of OMC, was to encourage his continued participation in the business. They transferred the OMC stock in trust for the benefit of their daughters primarily to provide them with the equity interest in the family business. Eugene was made sole trustee of the daughters' trusts to ensure that majority control of the outstanding shares of OMC stock will remain in the control of the Diedrich family.

Since petitioners were cash method taxpayers, respondent conceded that the gift taxes paid by the Donees in 1973 and 1975 are not at issue in this case which involves only taxable year 1972.

On their income tax return for 1972 petitioners did not report any income by reason of the transfers of the stock. In his statutory notice respondent determined that the transfers constituted exchanges of stock giving rise to income in the form of capital gain in 1972.

Opinion

The sole issue for decision is whether petitioners realized income on transfers of stock to or for the benefit of their children where the transfers were conditioned on the Donees agreeing to pay Federal and state gift taxes resulting from the transfers.

The basic facts are not in dispute. Petitioners made gifts of stock which had a fair market value in excess of their basis. The gifts were conditioned on the Donees paying all applicable gift taxes, which they eventually did. The gift tax liability exceeded the total amount of donors' basis in the transferred stock.

Respondent, relying upon *Johnson v. Commissioner* [Dec. 31,886], 59 T. C. 791 (1973), affd. [74-1 USTC ¶ 9355] 495 F. 2d 1079 (6th Cir. 1974), characterizes the transaction as in part a sale and in part a gift. He reasons that since the gift taxes on the transfer were the legal obligation of the donors,[1] Donees' payment constituted income which was in effect an amount realized as consideration for the transfer. This, he claims, resulted in income to the donors to the extent the payment exceeded their basis in the transferred stock.

Petitioners, relying on a long line of decisions from this Court,[2] maintain that they merely made a net gift of the difference between the fair market value of the stock and the gift tax paid. In characterizing a transaction as a net gift, we have repeatedly held that the donor does not realize income as a result of the transfer.

In each case involving facts similar to the ones before us, we have held that the transfer constituted a net gift

---

1. Sec. 2502(d), I. R. C. 1954.

2. *Estate of Henry v. Commissioner* [Dec. 34,960], 69 T. C. 665 (1978), on appeal (6th Cir. May 5, 1978); *Hirst v. Commissioner* [Dec. 32,868], 63 T. C. 307 (1974), affd. [78-1 USTC ¶ 9166] 572 F. 2d 427 (4th Cir. 1978); *Estate of Davis v. Commissioner* [Dec. 31,120(M)], T. C. Memo. 1971-318, affd. per curiam [73-1 USTC ¶ 9124], 469 F. 2d 694 (5th Cir. 1972); *Turner v. Commissioner* [Dec. 28,814], 49 T. C. 356 (1968), affd. per curiam [69-1 USTC ¶ 9416] 410 F.2d 752 (6th Cir. 1969).

resulting in no income tax liability to the donor.[3] We recently followed this approach for characterizing the transaction in *Estate of Henry v. Commissioner* [Dec. 34,960], 69 T. C. 665 (1978), on appeal (6th Cir. May 5, 1978). For the reasons set forth therein, we feel compelled to once again reject respondent's position that the transaction should be treated as a part-sale part-gift.

To reflect the foregoing,

Decision will be entered for the petitioners.

---

3. For this reason *Old Colony Trust Co. v. Commissioner* [1 USTC ¶ 408], 279 U. S. 716 (1929), as advanced by respondent, is not applicable.

APPENDIX D

JUDGMENTS

(Filed March 4, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1376

September Term, 1980

Victor P. Diedrich and Frances T. Diedrich,
Appellees,

vs.

Commissioner of Internal Revnue,
Appellant.

Appeal from the United States Tax Court.

This Cause came on to be heard on the record of the United States Tax Court, appendix and briefs of the respective parties and was argued.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the Tax Court in this cause be, and the same is hereby, reversed in accordance with the opinion of this Court.

Costs taxed in favor of Appellant:	March 4, 1981
Costs of five copies of appendix, five copies of brief and five copies of reply brief:	$204.60
Total costs of Appellant for recovery from Appellees	$204.60

(Filed March 4, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1421

September Term, 1980

United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, Deceased,
Appellee,

vs.

Commissioner of Internal Revenue,
Appellant.

Appeal from the United States Tax Court.

This Cause came on to be heard on the record of the United States Tax Court, appendix and briefs of the respective parties and was argued.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the Tax Court in this cause be, and the same is hereby, reversed in accordance with the opinion of this Court.

Costs taxed in favor of Appellant:	March 4, 1981
Costs of five copies of appendix, five copies of brief and five copies of reply brief:	$203.16
Total costs of Appellant for recovery from Appellee:	$203.16

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1421

September Term, 1980

United Missouri Bank of Kansas City, N.A., Executor of the Estate of Frances D. Grant, Deceased,
Appellee,

vs.

Commissioner of Internal Revenue,
Appellant.

Appeal from the United States Tax Court.

The Court, having considered appellee's petition for rehearing and suggestions for rehearing en banc and being now fully advised in the premises, hereby orders the petition for rehearing and suggestions for rehearing en banc denied.

March 27, 1981

(Filed March 27, 1981)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT
No. 80-1376

September Term, 1980

Victor P. Diedrich and Frances T. Diedrich,
Appellees,

vs.

Commissioner of Internal Revenue,
Appellant.

Appeal from the United States Tax Court.

The Court having, considered appellees' petition for rehearing and suggestions for rehearing en banc and being now fully advised in the premises, hereby orders the petition for rehearing and suggestions for rehearing en banc denied.

March 27, 1981